MTC Combined Report Briefing
Apportionment and Allocation of Partnership Income[1]

1. Trade or Business Imputation and Nexus. In general, the California apportionment rules for partnerships treat a partner as being engaged in the trade or business of the partnership, as if conducted directly by the partner.

    a. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership, or an S corporation, and is true whether the owner is a corporation or an individual proprietor (see Reg. §25137-1 and §17951-4).[2]

    b. Thus, if the partnership has California source income, so will the partner. This principle is consistent with federal sourcing rules that treat a resident of a foreign country as having U.S. source income if the partnership or an S corporation has income from a U.S. source (IRC §875(1); §1366(b)).

    c. The "as if done directly" theory of pass-through entity treatment was sustained by the Court of Appeal in *Valentino v. Franchise Tax Board* (2001) 87 Cal. App. 4th 1284. The court held that the California source income of an S corporation that had California source income was taxable to a nonresident shareholder, even though the shareholder had no other connection to the state.

    d. Nexus. As a correlative effect of the *Valentino* case, FTB staff is of the view that if a partnership has activities that exceed P.L. 86-272 (or create constitutional nexus), then each of the partners are treated as having conducted the same activities, and have therefore also exceeded P.L. 86-272 protections (and have constitutional nexus), and have done so for all purposes.

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[1] This outline was prepared by Michael Brownell, FTB legal. It is intended as a training outline for the MTC uniformity committee, and is not an official publication of the Franchise Tax Board.

[2] For simplicity, this outline will use the term "partnership" and "partner" to describe the treatment of pass-through entities, unless otherwise provided. In addition, the examples will refer to a corporate partner, but the rules similarly apply to individuals under Reg. §17951-4.

2. Unitary Partnerships.

    a. If a corporation has an interest in a partnership, and the partner and partnership are in a unitary business, the partner combines is own business income with its proportional interest in the partnership's business income.

    b. Unitary combination is appropriate even if the partner's interest in the partnership is less than 50%. Thus the normal corporate unity of ownership rules, used for combined reporting, do not apply, because the partner is seen as engaging in the partnership activity itself.

    c. **Example 1:** Assume Corporation A has $20,000 in business income, and is a 60% partner. The partnership has $10,000 of business income. Corporation A combines its own $20,000 with its 60% share of the partnership's income ($6,000), and apportions the combined $26,000.

    d. The combined income is apportioned using an aggregate apportionment percentage that reflects the partner's own payroll, property, and sales with its share interest in the partnership's payroll, property, and sales.

    e. **Example 2:** To illustrate, assume the same facts as example 1, except that Corporation A has $50,000 in California sales, and $100,000 in total sales. Assume the partnership has $30,000 in California sales and $60,000 in total sales.

        Corporation A's sales factor numerator is $50,000 + 60%($30,000), or $68,000 and its denominator is $100,000 + 60%($60,000), or $136,000.

    f. A more detailed unitary partnership example is seen in the Publication 1061, which is can be found at:

        http://www.ftb.ca.gov/forms/03_forms/03_1061pub.pdf

3. Non-unitary Partnerships.

    a. If the partner and partnership are not unitary, the partnership generally apportions its own business income at its level, using its own property, payroll, and sales.

b. The partnership then distributes to the partners their respective share of the partnership's previously apportioned California source income.

c. **Example 3:** Assume that a partnership has $10,000 in business income, and a 30% apportionment percentage, based on its own factors. Thus, the partnership has $3,000 of California source income. If Corporation A is a 60% partner, it reports $1,800 as California source income as if from a separate trade or business.

d. Rationale for this treatment. Although apportionment of nonunitary partnership income at the partnership level may seem a bit inconsistent with the theory that each partner is derivatively treated as engaged in its own trade or business by its investment in the partnership, this approach is employed because, in most cases, it is mathematically equivalent and it makes tax compliance much easier for the partners, because apportionment can be done once at the partnership level, rather than having each of the partners receive income and apportionment data and do their own apportionment.

    i. Apportionment at the partnership level, followed by a distribution of previously apportioned income, produces the same result as distributing income and factors based on percentage of ownership of the partnership interest, and treating the income and factors as a separate trade or business.

    ii. That's because the apportionment factors if distributed stand in the same ratio as the apportionment factors of the partnership prior to the distribution. (Mathematically, income x apportionment percentage x ownership percentage is the same as income x ownership percentage x apportionment percentage, if the apportionment percentage is the same.)

    iii. The reason apportionment of income of a nonunitary partnership is done at the partnership level is simply to avoid having to make partners, particularly personal income tax partners, from having to deal with the apportionment schedules, and income and factors, if they otherwise don't have to apportion. It is simply easier for the partnership to do it once, rather than have potentially hundreds of partners do it separately.

4. Mixed Unitary and Nonunitary Partners.

    a. Sometimes a partnership can have both unitary and nonunitary partners. The above rules are applied on a partner-by-partner basis.

    b. The unitary partner takes its share of the partnership's income and factors and combines the partnership income and its own income, at its own level, under the unitary rule.

    c. The partnership also apportions its total business income at the partnership level under the nonunitary rule, using the partnership's apportionment factors. The nonunitary partner takes its share of the income previously apportioned at the partnership level. (The unitary partner disregards the effect of the apportionment at the partner level.)

    d. **Example 4:** Assume the partnership has $10,000 in business income and has a 60% partner, Corporation A, and a 40% partner, Corporation B. Corporation A is unitary with the partnership and Corporation B is not.

        i. Corporation A will take 60% ($6000) of business income from the partnership, and its share of the partnership's factors, and combine income and factors on its own apportionment schedule, Schedule R.

        ii. For the nonunitary partner, the partnership will then apportion its total business income of $10,000 at its level. If it has a 30% apportionment percentage, the partnership has California source income of $3,000. Corporation B will take its 40% share of that $3,000 ($1,200).

        iii. Corporation A will disregard the apportionment at the partnership level, because it will have already taken its income into account by combination at its own level.

5. Partnerships Unitary with Each Other.

    a. Sometimes a corporation will own two partnership interests, and the partnerships are unitary but the owner is not.

    b. Reg. §25137-1 doesn't speak to that situation specifically, but by treating the partner as engaged in the trade or business as if done directly, the normal rule that unitary trades or business are combined apply to combine the two income streams *at the partner level*.

        i. Because both regulations treat the partner as being engaged in the trade or business of the partnership, the nonunitary partner is treated as being engaged in two separate lines of business, its own, and another line of business consisting of the two unitary segments distributed from both partnerships.

        ii. Thus, the practice of the department has been to combine prorata income and factors of the two unitary partnerships at the *partner* level.

        iii. The newer personal income tax regulation under Reg. §17951-4 specifically provides such a rule.

    c. Thus, a corporation takes its share of the business income from each of the partnerships, and its share of the factors from each partnership. The corporation the combines its share of both partnership's business income. That income is then multiplied by a composite apportionment percentage that consists of its share of the apportionment factors of both partnerships.

6. Unitary Treatment of Limited Partnerships.

    a. The regulations (both Reg. §25137-1 and Reg. §17951-4) do not distinguish between the treatment of limited partnerships and general partnerships for purpose of apportionment. Thus, there is nothing in the regulation that would prohibit combination of a limited partnership interest.

    b. Some have argued that income from a limited partnership should not be combined with the income of a corporate limited partner because the

limited partner cannot control the partnership. In some cases, that may not be factually true, because a limited partner might participate in the management of the limited partnership despite the risks to its limited liability status.

c. In addition, if the limited partnership has an important functional relationship to the taxpayer (e.g., a supplier of natural resources to an oil company), a unitary relationship might develop, despite nonparticipation in management decisions of the limited partnership.

d. In some cases, both the general partner and limited partners in a limited partnership may be members of the same commonly controlled group. Because the group, considered as a whole, has both a substantial equity interest in the partnership and control, combination of a limited partnership would be appropriate in most of such cases, if the other indicia of unity are present.

e. Thus, while factually unity may be less than likely in the case of limited partnerships, a limited partnership is not per se decombined.

7. Nonbusiness Income of a Partnership.

a. If a partnership earns nonbusiness income, the partner's share of that income is treated as if it had earned the income directly. Thus, if the partnership has a nonbusiness dividend, it is allocated to the domicile of the partner, NOT the partnership.

b. The rule also reflects the principle that the partner is treated as engaged in the activity of the partnership as if it had done the activity directly.

c. The rule also serves an anti-tax avoidance motive: a partnership's domicile is pretty easy to establish anywhere. If the partnership's domicile were used for the nonbusiness rule, a corporation could manipulate the situs of nonbusiness income merely by moving it into a partnership co-owned by another member of its group.

8. Tiered partnerships. Sometime a partnership can own another partnership which owns another partnership, etc. How would these rules work?

a. Neither Reg. §25137-1 nor Reg. §17951-4 specifically speak to this situation. However, as noted, the underlying principle of the regulations is that a partner is considered engaged in the activity of the partnership as if done directly. That principle applies through any number of partnerships, as well, because each partnership in the chain is "doing the business" of the preceding partnership.

b. Assume that Corporation A has an interest in Partnership P-1 and Partnership 1 has an interest in Partnership P-2.

    i. The theory of the regulations would mean that Partnership P-1 would be treated as being engaged in the business of P-2 as if it had done so directly.

    ii. If P-1 is considered engaged in the business of P-2, then Corporation A would likewise be considered in the business of P-2, because it is treated as doing all business activities of P-1.

c. Then it would be a matter of determining who was unitary with whom, and what the effect would be.

d. Assume P-1 and P-2 are unitary, but Corporation A is not. Under the theory described above, P-1 would take its business income and its share of P-2's business income and factors, and apportion income at its level, just as it would if it were conducting both of the unitary business segments itself. Corporation A would then take its share of the California apportioned income, under the nonunitary partnership rules.

    i. **Example 5:** Assume Corporation A has a 60% interest in P-1, and P-1 has a 40% interest in Partnership P-2. Partnership P-2 has business income of $5,000, and P-1 has business income of $6,000. Partner P-1 would take its 40% share of P-2 's income ($5,000 x 40% = $2000) and its 40% share of P-2's factors.

    ii. It would then add the prorata business income with its own business income ($2000 + $6,000 = $8,000) and then add its share of P-2's factors to its own factors, and apportion at its own level

(because it is not unitary with the corporate partner). Assume the resulting combined apportionment percentage is 30%. Partnership P-1 would have California income of $8,000 x 30%, or $2,400. It would then distribute that California income to its partners. Corporation A, as a 60% partner, would take $2,400 x 60% = $1,440 as California source income as if from a separate trade or business.

e. A similar "look through" analysis is applied if Corporation A was unitary with Partnership P-2, but not Partnership P-1 (that is, P-1 is an intermediate nonunitary entity).

   i. In that case, the income and factors of P-2 would flow through to Corporation A, based on A's indirect ownership of P-2. Using the same ownership percentages in the prior example, Corporation A has an indirect interest in partnership P-2 of 60% (its interest in P-1) x 40% (P-1's interest in P-2).

   ii. If Partnership P-1 had its own nonunitary business, income from that business would be treated under the normal rules that apply to nonunitary partnerships.

   iii. **Example 6:** Assume the same percentage ownership as the example before. Corporation A had business income of $10,000. Assume P-1 had income from its own separate business of $7,000, and an apportionment factor of 40% for that business. Assume that P-2 had business income of $6,000, and that activity was unitary with Corporation A. Corporation A would combine its business income of $10,000 with 60% x 40% (24%) of the $6,000 business income of partnership P-2 (or $1440), and 24% of P-2's apportionment factors. Corporation A would take a separate stream of income of $7,000 x 40% (P-1's own apportionment factor) x 60% ownership interest, or a resulting California source income of $1,680.

f. A similar analysis applies to nonbusiness income. If partnership P-2 had nonbusiness income of $5,000, Corporation A's share of that income would be $5,000 x 40% (second level ownership) x 60% (first level ownership), or $1200. That income would still be treated as if earned by Corporation A directly. If the income was from an intangible, such as

interest or dividends, it would be assigned to Corporation A's domicile, not the domicile of either of the partnerships.

9. The *Appeal of Saga Corporation* line of cases.

   a. In *Appeal of Saga Corporation*, SBE, June 29, 1982, the Board of Equalization had occasion to examine Reg. §25137-1. The department argued that a taxpayer had a unitary relationship with a partnership, and, even if the corporate partner had *a less than* 50% interest in the partnership combination of the income and factors of the partnership to the extent of the partner's interest in the partnership was appropriate.

   b. The Board agreed, finding the rationale of the regulation "compelling" and found that the theory of the regulation should be applied for years to which UDITPA is applicable.

   c. The department does not view a distribution from a nonunitary partnership as ordinarily constituting “nonbusiness income” to the partner. If the partnership is itself engaged in a trade or business, Reg. 25137-1 clearly adopts the principle that income from a nonunitary partnership is income from a "separate trade or business."

   d. Characterizing a nonunitary partnership as being a source of "nonbusiness income" is clearly not appropriate if the nonunitary partnership is itself an apportioning business. Thus, if a nonunitary partnership does business in California, its income is still in part apportionable business income, represented by the apportionment factors of the partnership.

   e. Thus, in most cases, distributive income from the trade or business of a nonunitary partnership is properly characterized as business income from a separate trade or business, absent unusual circumstances. For example, a distribution from a partnership might be entirely nonbusiness income is if the partnership itself had no core trade or business, but only held a series of unrelated nonbusiness activities.

   f. This would be analogous to the holding in *Appeal of Holloway Investment Company*, SBE, August 17, 1983, where the taxpayer had essentially a

series of nonbusiness investments, and no core apportioning trade or business.

10. Nonunitary partnerships in a commonly controlled group that are unitary with another member of the group. As discussed above, Reg. 25137-1 provides that nonunitary partnership apportion income at their own level, and unitary partners distribute income and factors to the unitary partner, and the income and factors are combined with the partner's income and factors. What happens in the following example?

    a. **Example 8.** Assume that Corporations A and B are members of a commonly controlled group, but are not unitary, and would not ordinarily file a combined report. Assume that corporation A has a partnership interest in P-1, but the partnership is not unitary with Corporation A. However, Corporation B and the partnership are unitary.

    b. Under the theory of Reg. 25137-1, Corporation A is engaged in the trade or business of Partnership P, even though not unitary. Thus, it is appropriate to characterize Corporation A's distributive share of Partnership P income as income from a separate trade or business. However, that separate trade or business is itself unitary with the trade or business of Corporation B. Thus, it would be appropriate to treat Corporation A's distributive share, and related apportionment factors, as properly included in a combined report that includes Corporation B's income and apportionment factors.

    c. Then, just as it would if it were conducting as separate trade or business directly, Corporation A would take its apportioned share of the combined report business income, based on its share of the factors from the partnership, under the principle of intrastate apportionment.

11. Mechanical rules. Reg. 25137-1 provides special rules for the treatment of intercompany sales between partners and their partnerships or vice versa. In general, these rules provide that intercompany sales are eliminated in the sales factor to the extent of the partner's interest in the partnership. In other words, the regulation treats sales to or from a partnership as the partner partially buying from or selling to itself. The department is studying the application of the combined reporting rules for intercompany transactions, and whether or not a deferred intercompany transaction system should apply to partnerships.

12. Partnership Apportionment Rules for Individuals.

    a. If an individual has two proprietorships, or a proprietorship and a partnership, or two partnerships, that individual still might have an incentive to manipulate income between the entities. Thus, there is still reason for applying the unitary method to prevent that.

    b. Thus, generally the same rules described above for corporations also apply to individuals that own pass-through entities (Reg. §17951-4).

    c. This caused some concern in the CPA community, because the determination of a unitary relationship was essentially a partner level responsibility, but the data to do the combination was maintained at the partnership level.

        i. Different CPAs would prepare the partnership returns than would prepare the individual returns, so information coordination was difficult.

        ii. In many cases, investors at a low level of ownership didn't have enough control of the pass through to manipulate prices, and often didn't have another entity that might have been unitary entity anyway.

    d. The department responded to that problem by creating a limited "no combination" safe harbor. Under Reg. 17951-4, if an individual partner subject to the personal income tax has an interest of less than 20% in the partnership combination is not ordinarily required. At 20% ownership, a level at which at most 5 partners would be affected, this seemed to be manageable for taxpayer compliance.

    e. However, a safe harbor can be abused.

        i. Family members could divide up their interests to individually fall below 20%, but the family could still run a unitary business, and manipulate income.

ii. To deal with that, the 20% threshold has an attribution rule in it, which treats all of the members of the family as owning each other's partnership interest. However, this rule applies only for causing the 20% safe-harbor to fail for unitary purposes; it does not otherwise affect the responsibility of the partner to pay tax on its own income. This will in many cases put family partnerships back over the 20% threshold.

f. Even 6 partners, each at 17% ownership, could collusively manipulate pricing between commonly owned partnerships. To deal with that, there is an anti-abuse rule that allows the FTB to force a combination in audit, if a manipulation of pricing occurs. The standard is the same as used for S corporations, which are discussed below.

g. The only other noteworthy special rule for partnership held by individuals is a partnership engaged in a profession, such as law, accounting, or architecture. Many of these firms are apportioning entities. Most partnerships do not pay their partners a salary, so the regulation imputes a payroll to each partner equal to 60% of the partner's distributive share for purposes of the partnership's payroll factor.

13. Partnership and a Corporation held by an Individual.

a. As noted, the rules described above generally apply to individuals, as well as corporations. What happens if an individual owns a corporation and a partnership interest, and it appears that the corporation and the partnership are unitary?

b. Recall the principle that a partner is considered to be doing the business of the partnership as if done directly. Thus, it is as if the corporation had one business and the individual had another.

c. In general, the department does not require a unitary combination of the income of an individual proprietor and a corporation. Thus, the individual's share of partnership income would not ordinarily be combined with the corporation.

d. Thus, if a corporation owns a partnership, the corporate partner's share of distributive income of the partnership is combined with its own income at the corporate level. If a partnership owns a corporation, the partnership income is treated as earned by the individual partners. Thus, the

corporation income is not ordinarily combined with the individual partner's distributive income.

e. However, an individual might have an incentive to manipulate income between a proprietorship and a corporation, or between a partnership and a corporation. In that case, the department has an anti-abuse audit tool under section 25102 to require a combined report, if necessary to reflect the proper income.

14. Special Rules for S corporations.

a. Standard corporations are not qualified to be shareholders in an S corporation. Thus, Reg. 25137-1 would never be utilized for in that context for corporations subject to the Corporate Tax Law.

b. S corporations are hybrids under California law. Unlike federal tax law, a corporate level tax is imposed on an S corporation at a 1.5% rate. This rule was not based on any particular policy argument; it was strictly a means to save some of the revenue from straight conformity to federal tax law.

c. For purposes of the 1.5% tax, an S corporation generally cannot be included in a combined report with any other corporation (section 23801(d)).

i. However, an anti-abuse provision was added to allow the Franchise Tax Board discretion to combine an S corporation and a C corporation (or two S corporations) if necessary to reflect income.

ii. However, to require combination, the FTB must first determine that there is no comparable uncontrolled price to use instead, as defined in section 482, IRC regulations. In general, a comparable uncontrolled price is a well-established market value for goods and services between the taxpayer and an unrelated party.

d. Note that the bar against combination applies only for purposes of the 1.5% tax at the S corporation level. Because an S corporation is otherwise treated as a partnership, combination can still occur at the shareholder level.

i. Thus, if S-1 and S-2 are unitary, and both have the same 50% shareholder, individual A, the individual takes its share of the income and factors of the two S corporations, and apportions its share of the business income of both, at the shareholder level, just as described above for partnerships.

ii. Note that because this rule only has effect at the shareholder level; none of the other shareholders are affected, unless they also own shares in both. If one S corporation operates at a gain and another at a loss, this will have effect only at the individual shareholder level and will not impact minority shareholders.

e. Another illustration of the hybrid nature of an S corporation is the difference in the treatment of nonbusiness income from intangibles.

i. If an S corporation has nonbusiness income, it is taxed as a corporation at 1.5%, and the nonbusiness rules of UDITPA assign the income to the S corporation's commercial domicile for purposes of its tax.

ii. However, when the nonbusiness income is distributed to the shareholder it is treated as if earned by the shareholder directly (as in the manner for partnerships), and is therefore assigned under the normal personal income tax sourcing rules, as if owned directly, which will generally assign intangible income to the state of residence under the *mobilia* rule.

15. Sale of a Partnership or S Corporation Interest. Because a partnership is a conduit, the partner is considered engaged in the business of the partnership for purposes of the distributive income of the partnership. What happens when the partnership interest is sold?

a. In *Appeal of Holiday Inns*, *supra*, the taxpayer owned a real estate partnership based in California. For years, the partnership generated losses, which the parties stipulated were California nonbusiness loss. Those losses were deducted against Holiday Inn's hotel business income apportioned to California.

b. The taxpayer argued that income from the sale of the partnership interest should be allocated to its Tennessee commercial domicile. The Franchise Tax Board argued that the gain should be allocated to California, where the underlying property and activity of the partnership was located.

c. The department also argued under section 25137 (section 18 of UDITPA) that it was anomalous for the gain on the partnership interest to be allocated to commercial domicile when, if the partnership had itself sold the property, the gain on that sale would be entirely California source income.

d. The Board of Equalization held that Section 25137 could not be invoked because the department had not proven distortion. The fact that gains on the sale of the partnership interest was treated differently than if the partnership property itself had been sold, simply reflected the fact that different interests were involved, the first being an intangible, and the second real property.

e. The Board of Equalization held to similar effect on the PIT side in *Appeal of Amyas and Evelyn Ames*, et al., SBE June 17, 1987.

f. After the *Holiday Inns* case, the MTC became concerned that the holding would invite taxpayer manipulation. If a taxpayer wanted to move gain or loss to commercial domicile, it would sell the partnership interest, but if it wanted to leave gain where the underlying property was located, it would sell the underlying property instead.

    i. By resolution, the MTC recommended member states adopt a statutory override in UDITPA to overcome the result in the *Holiday Inns* case. That override is reflected in California section 25125(d).

    ii. Section 25125(d) approximates the effect that would occur if the underlying property of a nonbusiness partnership were sold. Gain or loss from the partnership is allocated based on the property factor of the partnership. Property factor was used as a rough approximation to avoid having to do a property-by-property valuation of property held by the partnership.

iii. However, if more than 50% of the assets of the partnership consists of intangibles (in many cases this will be goodwill or market intangibles) the prior year's sales factor of the partnership is used to distribute the gain or loss.

g. If the partnership interest is a business asset under the functional or transactional test in the hands of the seller, the gain on the sale of the partnership interest is treated like any other business intangible, resulting in apportionable business income. *Appeal of Centennial Equities, Inc.* SBE, June 27, 1984.

Although the case did not address the question, because there is no other regulatory rule to the contrary, presumably the sale of the partnership interest would be assigned to the sales factor numerator based on the location of income producing activity based on cost of performance under Section 25136, analogous to the treatment of sales of business stock.